# DR. KURT RICHEBÄCHER

## CURRENCIES AND CREDIT MARKETS

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"Early in 1928, the nature of the boom changed. The mass-escape into make-believe, so much part of the true speculative orgy, started in earnest."

The Great Crash, J. K. Galbraith, p.16.

## HIGHLIGHTS

Unchastened by the many economic disappointments so far, most consensus forecasters choose to ignore the seriousness of present world economic conditions.

Booming financial markets, scaling new highs almost everywhere around the globe, make a mockery of the few serious analysts who see the stark contrast between buoyant markets and gloomy economic reality as the latest and most dangerous expression of the excesses of the 1980s.

Every speculative era has its crackpot theories that feed the rampant delusions. We identify four of such theories existing today.

In the Anglo-Saxon countries, Nordic countries and Japan, the credit and debt excesses and the resulting structural distortions to their real economies were unprecedented in the 1980s. Unavoidably, overcoming these distortions is a painfully long ordeal. It is far from over.

Japan is a special case among the bubble economies. It seems headed for more trouble. The big unknown is its stock market. Any further decline from present levels could jeopardize the financial system, the economy, and the yen.

The calamitous fact about the U.S. and the other Anglo economies is that they have all progressively looted their capital formation and thereby have shrunk their industrial base and long-term growth potential. In this respect, the situation is even worse than it was in the 1920-30s.

We are probably witnessing today the biggest collapse in the demand for liquidity in history. An enormous liquidity trap is being set. We ponder what will eventually set it off.

The crucial question for Germany is whether the unification burden might damage German capital formation and long-term growth potential in the mould of America, Britain, Canada and Australia. While the budget deficit is indeed awful, we see reasons to be optimistic.

The dollar has rallied recently against the D-mark. Again, we think the foundation of this rise is nothing more than wishful thinking. We explain.

We have recommended the bonds of the hard currency countries for capital preservation and capital gains for quite some time. It has been a profitable and comfortable strategy. But now it becomes more difficult. Interest rates have fallen everywhere. Investors will increasingly need to be satisfied with capital preservation, nothing more. To that end, short-term cash securities and shorter-term bonds in the hard currencies are most attractive.

## ON BORROWED TIME

Looking ahead, only two outcomes are possible for the world economies and financial markets: Either the world economy begins responding to the pushes of policymakers, or it doesn't. In the first case, it would barely forestall further deterioration in government deficits and employment and perhaps soften the coming financial bedlam. In the latter scenario, an outcome with significant odds in our view, would mean that serious troubles are imminent. Realistically, a strong world recovery is virtually out of the question.

In the meantime, growth estimates for the world economies continue to be steadily revised downward — already for three consecutive years in the case of such supra-national agencies as the International Monetary Fund (IMF). For example, a year ago, it projected aggregate economic growth of 2.9% for the industrial countries in 1993. Half a year later, the estimate was slashed to 1.7%. Recently, it was cut further to 1.1% growth at best. Revealingly, the IMF's director of economic research had the candour to admit that "*things might not go quite as well as we expect.*"

It has always been those things that were not expected by the consensus and these forecasting agencies that have happened. Just what is it that they don't expect this time?

## REVIEWING THE RECORD

Economic forecasters, official as well as private, have hardly basked in glory in recent years. They've consistently been over-optimistic, first about the depth and longevity of recession and then about the likely strength of recoveries. Clearly, what we are witnessing is the worst slump in the world economy of the entire postwar period. No sooner do economic recoveries appear to strengthen, they again slow down — Britain, the U.S. and Canada, are prime examples in this regard. In other countries, Japan, for example, downturns are verging on the terrifying. Yet, despite all this apparent doom, there seems to be an unshakable complacency about global economic prospects. Ignoring the many economic disappointments so far, few are inclined to recognize the seriousness of world economic conditions. What we see instead are booming stock markets virtually everywhere prancing from one new high to another. One might be forgiven for thinking that this must be the best of all worlds for businesses.

Actually, surveys — from Japan to Britain, Continental Europe and the U.S. — show that businessmen are anything but optimistic. At best, they expect sub-par growth and stiff competition. Many, too many, are preparing for worse to come by retrenching . . . by downsizing and restructuring in other words. It's hard to believe that anybody could be cheered by such a vast display of corporate self-mutilation. Businessmen and workers surely aren't. Only the stock exchanges and bond markets rejoice. But, for how long?

Our readers know that we have been on the pessimistic side of the opinion spectrum for a while . . . in fact, some years. It's not that we are pessimistic by nature; it's just that we recognized the omens to today's deteriorating conditions well in advance of anybody else. It is a fact, after all, that this world economic crisis has completely taken policymakers and the great majority of economists by surprise. To recall, the happy consensus view of the 1980s was that it was a period of healthy growth, low inflation, the very antithesis to the inflationary 1970s. Soaring stock and real estate prices were welcomed as the rosy rewards of economic health and low inflation.

By contrast, we had been forewarning that the inflation in the 1980s was much more rampant than

before. What few recognized was that it had changed its outlet. While the inflation of the 1970s mainly affected the prices of goods, services and tangible assets, that of the 1980s dispersed into asset price inflation (affecting such things as real estate, financial securities and other real assets) and unprecedented trade imbalances.

The trouble was that policymakers and virtually all economists didn't recognize these developments as signs of a rampant inflation. In complete ignorance of what was really going on, many actually raved about a new era of disinflation. Thus, the soaring stock and bond prices during the 1980s were seen as being perfectly warranted. In the same vein, exploding trade deficits were heralded as a positive development. The view was that they reflected strong growth and the eager willingness of foreigners to invest in the deficit countries.

## THE IMPACT OF ASSET PRICE INFLATION . . .

Along with its regular publication, World Economic Outlook, the International Monetary Fund last May published a study about "asset price inflation." The authors admit that the conventional measures of inflation — which focus on the price indexes of goods and services — had not provided an accurate assessment of the inflationary pressures that were building during the mid-1980s. In many countries, the money supply expanded far in excess of the growth of Gross Domestic Product (GDP). But since the inflation rates for goods and services declined, this "*excess money growth was discarded as an irrelevant decline in money velocity.*"

Informative as this study is, it wrongly confined its discussion to the monetary aspects of asset price inflation and completely ignored the massive structural maladjustments that asset price inflation inflicted on the real economies. There is a comforting notion that an asset price bubble is somehow distinct and separate from the real economy and therefore can have no ill effect.

To believe that is a fatal error. Soaring asset prices are the direct effect of monetary inflation. The secondary effects of asset inflation, though, are much more virulent and dangerous. What happens is that consumers and businesses are encouraged to use the inflating asset values as collateral to boost their borrowing and spending. This spending, fed by a borrowing binge, is the channel through which the asset price inflation finally impacts and ravages the real economy, thus sowing the seeds of a protracted structural crisis that follows.

For most economists today, monetarists and Keynesians alike, such theories of economics are an unopened book. Instead, knowledge of history and theory has been replaced by mindless computer models. Actually, the notion that asset price inflation leads to a protracted structural crisis is nothing new, neither in history nor in theory. It was perfectly explained by the Austrian school of economics — promoted by Ludwig von Mises, Friederich Hayek, and others — which principally stressed the structural ill effects of a prolonged monetary inflation on the real economy. And, of course, a famous, historic precedent for this was the U.S. asset price inflation of the 1920s.

## . . . AND ITS DIFFERING AFTER-EFFECTS.

The asset price inflation that gripped most of the world during the latter 1980s was worse in some countries than others. The Anglo-Saxon countries (Australia, Britain, Canada, the U.S.), the Nordic

countries (particularly Norway and Sweden) and Japan were particularly affected. In the main, Germany and the countries of the narrow DM bloc — including Holland, France and Austria — mostly avoided the debilitating effects of asset price inflation.

In the Anglo-Saxon and Nordic countries, the credit and debt excesses were unprecedented, and essentially, so were the resulting structural distortions to their real economies. Working these distortions off — the healing process, so to speak — is a painful and long ordeal which inevitably constrains economic growth. Inventory imbalances can be quickly corrected; excess structures and capacity take years to absorb. The debt problems that are usually associated with these distortions are yet another problem and cause additional burdens.

## CREDIT AND DEBT EXCESSES: THE ANGLO CASE

A common aspect of all inflations is that they are always credit and debt inflations. However, their effects on the structures of the real economy may differ diametrically. Depending on who does the big borrowing — businesses, consumers or the government — credit excesses either lead to huge malinvestments or overconsumption or possibly both.

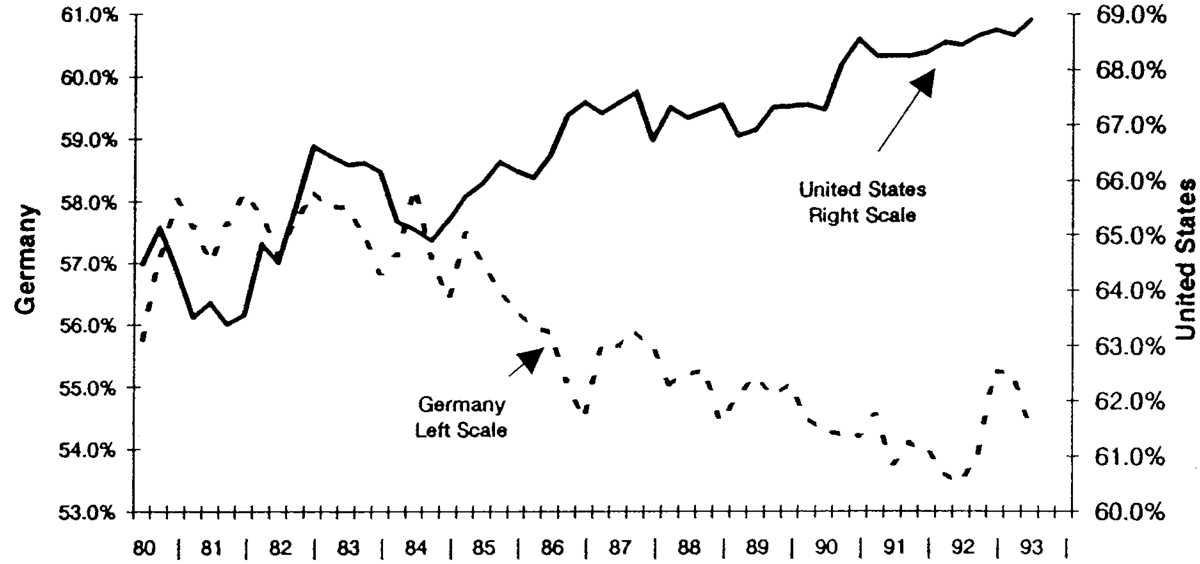
Today, we see both examples in the world. In most countries, the inflation of the 1980s went mainly into consumer and government spending. Japan is the major exception. There, super-low interest rates and soaring asset prices mainly fuelled a domestic and international capital spending boom on industrial plants and real estate. Yet, despite Japan's thrifty culture, consumer debt exploded, also.

In the Anglo-Saxon and Nordic countries, the inflation of the 1980s had one distinguishing, common feature: private consumption and government spending accounted for a growing share of GDP at the expense of both capital investment and the trade balance. (The graph on the next page shows the growing role of consumption in the U.S. economy and contrasts it with the trend in Germany.) While the consumption boom did stimulate investment spending, it was heavily directed towards consumer services and short-lived assets, causing overinvestment in these assets at the expense of spending on manufacturing. The easily visible overall effect of these pronounced changes in the structure of these economies were sliding investment ratios and ballooning trade deficits.

What's the problem with such a structural shift in the composition of GDP away from investment toward consumption? In short, two things. Firstly, the inflation of consumer demand, fuelled by a borrowing binge and large budget deficits, leads to massive malinvestments — for example, too many retail malls, hotels, restaurant chains, consumer goods plants, office buildings and other things catering to consumers. This only becomes obvious when the borrowing subsides. Huge losses, vacancies, write-offs and debt-defaults are the result. Secondly, by deforming their capital formation both in quantity and quality, all these countries have constrained the long-term growth potential of their economies.

## THE JAPANESE SITUATION

The special case among the bubble economies is Japan. To begin with, its financial mania was the wildest that the world has seen. Secondly, it sucked the super-efficient manufacturing sector that had created the economic miracle into a whirlpool of financial speculation that spurred gigantic corporate malinvestments, both domestic and international, in industrial plant and real estate.




Source: U.S. Department of Commerce, Deutsche Bundesbank

Astronomic price-earnings ratios — 60, 80, 100 times and more — became the norm in the Tokyo stock market. But just as they are doing today, the pundits creatively invented semi-plausible rationalizations that seemed to justify such lofty stock prices. These explanations conveniently circumvented the true cause of Japan's sky-high stock and property prices — the country's prolonged period of rock-bottom interest rates and double-digit money and credit growth. To recall, in the period between January 1986 and February 1987, the Bank of Japan slashed its discount rate from 5% to 2.5%, leaving it at that level until Spring 1989.

It only took a few interest rate hikes to burst the bubble and soon be followed by a sharply weakening economy. As money and credit growth virtually collapsed in early 1991, the Bank of Japan began easing again, progressively cutting its discount rate to a new low of 1.75% presently. Steep interest rate cuts and three supposedly huge fiscal stimulus packages may have contained the recession. Nonetheless, these measures have completely failed to revive the economy. Government spending and residential construction are its only supports.

The outlook remains grim. Sliding exports now join slumping investment and consumer spending. While corporate profits are in their fourth year of decline, stocks are trading around 80 times earnings and over 100 times prospective earnings. Yet, any serious decline in the stock market from present ridiculous valuation levels would jeopardize the financial system and the economy.

## A DIFFERENT SITUATION: GERMANY AND THE DM BLOC

The other end of the spectrum is typified by Germany. True, it has become fashionable to be

particularly pessimistic about the German economy. Horror stories about the costs of unification and the disastrous development of its international competitiveness abound.

Serious policy mistakes — for political reasons — definitely made German unification far more costly than was necessary and originally envisaged. Another misfortune was that the budget-fed unification boom came when the West German economy was already booming, thus fuelling inflation pressures in both product and labour markets. In response, the Bundesbank tightened its reins, driving up interest rates sharply.

The crucial question is whether the unification burden might devastate German capital formation in the same mould of America, Britain, Canada and Australia. Could unification damage Germany's long-term growth potential?

That, indeed, is the paramount issue. To prevent any such long-term damage, what's required is wage moderation and measures to curtail the budget deficit in future years. It appears to us that the politicians and the public in Germany have accepted this necessity. There is much to be criticized in the details of the fiscal consolidation measures proposed so far, but the direction of the thrust is unmistakable.

## THE GERMAN BUDGET DEFICIT: THE BIG, BAD SPOILER?

The German budget deficit plays a prominent role in the horror stories about the German economy and the D-mark. But really, how bad is it? Admittedly, it's bad . . . though we must add, not nearly as disastrous as in many other countries. Debts and deficits should always be assessed relative to available domestic savings. From this perspective, the budget deficits of the Anglo countries and others are much worse.

During 1993, total public borrowing in Germany — taking the widest definition which includes the railway and postal operations — is expected to reach DM 242 billion ($U.S. 144 billion). That would represent almost 9% of pan-German GDP. Looked at differently, it would be equivalent to 93% of available domestic personal savings which amount to about DM 260 billion. According to the government's implemented budget restraint measures, this ratio is set to fall to 64% by 1995.

In the United States, the current budget deficit is only 4.2% of GDP. Employing the same definition of government borrowing we used for Germany, total public borrowing in the U.S. would be much higher . . . probably nearer 8% or 9% of GDP. But given its abysmally low savings ratio, the current budget deficit alone amounts to about 150% of available domestic personal savings. Total government-related borrowing requirements would be much higher.

The most simple and best measure of the balance or imbalance of an economy is its balance of payments with the rest of the world. Here again, we notice a remarkable inconsistency in the application of this principle. When some other countries show persistent, chronic, and much larger deficits, these are taken to be the express result of economic strength. But when Germany recently recorded its first current account deficit in many years, it was immediately pounced upon as proof of a disastrous lack of competitiveness.

If the German economy is so hopelessly uncompetitive as many reports suggest, it is indeed remarkable

that it is still running a considerable trade surplus of about DM 50 billion annually. The trade surplus had peaked at a level of DM 146 billion prior to unification. What's caused a German current account deficit of around DM 40 billion (presently 1.2% of GDP) even with a trade surplus are mainly non-economic factors such as sharply growing net transfer payments in support of the European Community (EC), reaching DM 22 billion this year.

## THE RELATIVE OUTLOOK FOR THE U.S. DOLLAR

By contrast, according to almost all of the reports we read, U.S. industry is unrivalled in competitiveness. In terms of certain comparisons for some sectors that may well be true. But let's use some common sense. Why does such a super-competitive economy have one of the lowest investment ratios in the world and a large, chronic trade deficit, even despite feeble GDP growth?

Another trend doesn't square with the claims of U.S. competitiveness and dollar strength either. Since the end of 1989, U.S. real GDP has grown by a cumulative total of 5.0%. During the same period, import volume rose 20.4%, of which non-oil imports rose even faster at 27%. Such a huge rise in imports is incompatible with all the bravado about competitiveness.

Nevertheless, the big bullish argument in favour of the U.S. and the dollar, repeated endlessly amongst the dollar bulls, is that its economic performance, although disappointing, still looks a lot better than most other Western countries. Case in point: U.S. GDP has been rising this year at plus 2% while the German economy has fallen 2%. (See the comparative graphs on the next page).

It sounds like a very convincing argument, doesn't it? It's really a gross misrepresentation of facts because it compares two economies that are in entirely different phases of the business cycle. Germany is in the first year of a voluntary recession following a big boom; the United States is in the third year of a disastrously feeble recovery, making for a four-year string of extremely feeble growth despite massive efforts to perform better.

What this twisted and distorted comparison really serves to do is distract attention away from the U.S. growth fiasco and to make it appear as a smashing success instead. Measured from the end of 1989, German GDP is up 8.4% and U.S. GDP is up 5.0%. Today, when trying to assess the economic situation of any country, it is important to distinguish between short-term cyclical and long-term structural conditions, in other words, between mere oscillations and real long-term growth dynamics. Why? Because the present worldwide pattern of recessions and feeble economic growth have both cyclical and structural roots.

## IN SEARCH OF A LOCOMOTIVE

Although we wanted to put the extremely negative reports about the German economy into perspective, we also ought to stress that we are not at all optimistic that Germany can expect a better or earlier recovery than other major countries. Our basic assumption is that growth conditions remain bleak and fragile worldwide. Recessions may have been contained but nowhere in the Western world is there the trace of a possible self-sustaining, let alone, self-reinforcing recovery.

In our view, the greater possibility is that the anaemic U.S. and U.K. recoveries will give way to new

downturns. In both countries, the recoveries are too shaky and ill-structured to gain sustained momentum. As well, continuous sluggish broad money and credit growth signal that monetary easing is still not reaching the real economies. Most of the stimulus evaporates into inflated bond and stock prices. Nor are there any signs that the disrupted transmission mechanism of easy money to the real economy is improving. Observing the feverish financial markets, instead of rejoicing about low and falling interest rates, it's high time to worry about their lack of impact on the real economies.


Source: U.S. Department of Commerce, Deutsche Bundesbank

Both the U.S. and U.K. recoveries, not to mention Canada, Australia and others, have been fragile right from the start for two reasons: too little investment and too much consumption. Far from improving, the structural savings-investment shortages are worsening. In Britain, the main culprit is the exploding budget deficit; in the United States, the main culprit is the consumer who is embarking on a new borrowing binge at the expense of savings. Borrowing in both countries is entirely for consumption purposes either public or private. There is literally no borrowing for investment.

The salient, calamitous fact about the U.S. economy — and the other Anglo economies — is that they have all progressively looted their capital formation and have thereby shrunk their industrial base. It's what Hayek called "*capital consumption*" and a "*shortening of the production structure*," due to declining savings and a rising share of consumption in total demand. For Hayek this was the structural

process that led to declining living standards, and over the long run, to depression.

It's Hayek's influence that causes us to focus so heavily on savings and investment. And on that score, the situation in the Anglo-Saxon countries is the worst ever . . . even worse than in 1929 and the following years.

## SIZING THE U.S. RECOVERY

U.S. GDP growth accelerated to a 2.8% pace in the third quarter up from 1.9% in the second quarter. Is this significant? The first thing to note is that these are all annualized rates. The true rise in the growth rate is 0.5% to 0.7%. The worst aspect of the third quarter figures is the fact that the entire "boost" came from lower savings and higher consumer borrowing. The total increase in consumer spending of $35.2 billion literally matches the total GDP rise of $35.9 billion (both figures in 1987 dollars).

Real consumer incomes during the recent quarter only rose 2% at an annual rate, barely half the rate of the 4.2% increase in consumer spending. In the meantime, consumer borrowing is up sharply since the beginning of the year. The result is that the savings rate has fallen precipitously, from 5.1 % in 1992 down to 3.7% in the recent third quarter.

If any more evidence were needed that the U.S. economic recovery is vulnerable to a downturn, the third-quarter data expels all doubt. It should be completely obvious that the American consumer is absolutely unable to lead a sustained recovery, even if the financial boom continues for a while longer. The wealth effects of the financial mania have likely been the key stimulus to this mini-borrowing and spending binge. Literally speaking, it's a recovery living on borrowed time.

Easy money and the booming markets have failed to stimulate a solid recovery. Yet, if there weren't a financial boom in the interim, there would certainly already be a deep recession. This raises two questions: How strong is the economy and how stable are the markets? Which one is more vulnerable, and if one topples how susceptible will the other one be?

## CRACKPOT THEORIES, VINTAGE 1993

As we've said, expectations for the U.S. economy have consistently been far too optimistic over the past three to four years. They still are. But miraculously, every new up-tick seems to create the same new euphoria as before . . . as if there is no collective memory.

Preposterously, Wall Street and the City of London pundits have succeeded in turning a tale of economic decline into the most bullish story ever told for the financial markets. The lessons of the story they want us to believe is that sluggish growth is a panacea for the economy and the markets because it assures low inflation and low interest rates.

Every speculative era brings forth its own crop of crackpot theories which are designed to justify the craziness. Slogans which condone record-high valuations and predict still higher prices in the future are eagerly seized upon. In the late 1980s, when Japan experienced its bubble, it was argued that "Japan is different," that Japan and its people had some mysterious and unquantifiable prowess. During the

1920s, U.S. stock speculation was enhanced by the slogan that the economy had entered a "New Era" of price stability in which stock prices could only rise and never fall.

Such crackpot theories again abound. We see at least four of them:

(1) A new era of low inflation and sluggish growth will lock the Fed into permanent monetary ease contributing to incredibly low interest rates for perpetuity.

(2) That the bull markets are "liquidity-driven", given vast pools of liquidity searching for investment.

(3) That corporate profit and cash flow increases are guaranteed because businesses will boost their productivity through savage cost-cutting and widespread "downsizing."

(4) That prevailing worries and bearishness — the popular contrarian argument — are sure-fire insurance against another crash.

Reflecting on these bullish arguments, we conclude that there is plenty of confusion, illusion, and deception. To quote Schumpeter: *"It remains true that irrational fancy and downright foolish hopes count for much in the short run. But it is no less true that they never prevent the real state of things from asserting itself eventually."*

## THE REAL STATE OF THINGS

First of all, corporate shrinkage through cost-cutting and downsizing is no recipe for raising profits in a slow-growth economy. People held this same conception in the 1930s, prompting Keynes to say the following: *"In this quandary individual producers base illusory hopes on courses of action which would benefit a few so long as they are alone in pursuing them, but which benefit no one if everyone pursues them."* Cost-cutting all around is really tantamount to cutting overall purchasing power which in turn depresses profits and the economy.

Due to the belief that economies are swimming in an ocean of liquidity that's literally spilling over into the financial markets, the biggest illusion about the financial boom is that it is "liquidity driven." In measuring the liquidity of economies, we must distinguish between existing money stock and new inflows. The incontestable measure of new inflows is broad money growth (M2, M3 or M4).

There is of course a huge pool of existing liquidity. The new inflows, though, are at their lowest pace ever of the whole postwar period. Taking the U.S. case during the decade between 1979 and 1989, total liquid assets held by consumers and businesses as measured by M3 expanded 125% or 12.5% per annum. During the three-and-a-half years since the end of 1989, U.S. M3 crept up by a mere 2.7% or 0.77% per annum. From this perspective, all the talk of "liquidity-driven" markets is absurd.

But what else is there that's lubricating this frenzied speculative boom if not liquidity? In short, it's a virtual collapse in liquidity preference. People are fleeing liquid assets — money market securities, deposits — like from the plague. Instead, they are favouring stocks, bonds and other marketable assets in their desperate quest for higher investment returns because the yields on liquid assets have been

slashed to a pittance.

It has been calculated that every one percentage point decline in existing short-term investments shifts roughly $150 billion of short-term money into stocks and bonds. It is true that the liquid investments of consumers have fallen as a portion of their total financial assets from 21% in 1990 to less than 15% recently. Far from being driven by excess liquidity, this financial boom is chased by rapidly shrinking liquidity as investors progressively sacrifice liquidity in the hope for higher yields and returns. More correctly, this boom is "illiquidity driven" and its most obvious cause is rock-bottom interest rates.

Who has set and determined such low interest rates? The U.S. Federal Reserve. It has done so alone by way of keeping its Fed funds rate at an extremely low level of 3% since July 17, 1992, a period of 16 months. This rate and the associated bank deposit rates of 2.50-2.75% are grossly out of line with the high budget deficit, the poor savings level, the inflation rate and the long-term interest level.

But couldn't abnormally low rates have undesirable and deleterious consequences? According to the vast majority, the general answer is a resounding "no". After all, cheap money is the traditional fetish of American policymakers and economists.

We see it very differently. The costs and risks of such low interest rates are the appalling imbalances and instabilities that build up in the financial system. A most obvious result is that securities prices are inflated to insane valuations levels. There is little doubt that a rapidly shrinking liquidity base and the massive yield-curve speculations which amount to hundreds of billions of dollars will eventually result in a foreboding crash.

Normally, the killer of bull markets is rising interest rates. Since we expect prolonged economic sluggishness at best, and therefore continuing low, short-term interest rates over the foreseeable future, should that guarantee continuing financial nirvana? To think that would be nonsense.

What else, then, could prick the bubble? We see two, interactive, forces: firstly, borrowing a term from the 1920s, the "bicycle effect." The market, like the bicycle, keeps its balance as long as it moves ahead. But as soon as the forward motion stops, it falls and throws its rider. As well, future expectations play a role. With dividend yields just as unattractive as short-term interest rates, the market must therefore depend on the expectation of future price appreciation. Physically, that cannot be an endless process. As expectations weaken, inflows will decline, triggering a self-reinforcing fall in the market.

We think the greatest danger for the U.S. and other stock markets will be a pronounced relapse of the U.S. economy. That will surprise and shock almost everybody. We see at least five influences almost certainly contributing to that likelihood: (1) more fiscal restraint; (2) further trade deterioration caused by weak exports and strong imports; (3) an inevitable consumer retrenchment; (4) sluggish, if not falling, investment; and (5), declining overall business profits.

## CONCLUSIONS

The dollar is temporarily supported by slightly better economic data. Once again, it's much ado about nothing. The modest rise in domestic demand couldn't be more ill-structured. It's being fuelled by an

unsustainable, new consumer borrowing binge which, in turn, is stimulated by the wealth effects of the financial boom.

Present economic momentum will therefore be short-lived. The U.S. economy's next major move is to the downside . . . at the latest in early 1994. Its severity will depend on what happens to the financial markets.

But isn't a weakening economy even more bullish for the bond market? In theory, yes; in practice, probably not. By undermining credit quality, it would certainly devastate junk bonds. As well, the budget deficit would balloon.

The U.S. stock market, driven by the panic escape from abysmally low interest rates, is extremely vulnerable. Needless to say, a sharp decline on Wall Street would cast a long shadow over all world stock markets. But it is Japan and the United States where the contrast between financial fantasy and economic reality is the most extreme.

What should investors do? In the pursuit of capital preservation and capital gains, we have recommended the bonds of hard currency countries for quite some time. It has been a profitable strategy with little risk. However, looking forward, the prospect for further capital gains are becoming limited. Interest rates have fallen everywhere. Although long-term rates may fall somewhat further in selected countries, the bulk of the declines are probably already behind us. Increasingly, therefore, investors will need to be content with capital preservation only.

To those investors resident outside of the hard-currency bloc, we recommend that they focus on short-term cash securities domestically and shorter-term bonds and cash securities of the hard currency countries. The countries that continue to make the grade, in our opinion, are Germany, Switzerland, Austria, and Holland.

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Publisher and Editor, *Currencies and Credit Markets*: Dr. Kurt Richebächer, Mendelssohnstrasse 51, D-60325 Frankfurt, GERMANY
TELEPHONE 49-69-746908 FAX: 49-69-752583
Associate Editor: Wilfred J. Hahn, CANADA

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